Software Companies and the R&D Credit

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Both start-up and mature companies investing in software development should assess their research and development activities, and evaluate whether they are eligible to claim the federal tax credit ("R&D credit") for increasing research activities provided under Internal Revenue Code ("IRC") Section 41. The company may be eligible for the R&D credit if it is developing and/or improving software and technology.

Enacted in 1981, the R&D credit has historically been popular with companies in the manufacturing and distribution industries. However, this is an often-overlooked tax savings opportunity for software companies. This dollar-for-dollar tax credit which offsets the company's regular federal income tax liability improves cash flow, allowing the company to further invest in new employees, technologies, and other business opportunities. The R&D credit may be claimed by companies structured as Subchapter C corporations and also by pass-through entities such as Subchapter S corporations and partnerships. The amount of research credit computed for pass-through entities is allocated proportionately to owners, similar to other attributes of the business.

Assessing the Company's Activities

The first step in determining eligibility for the R&D credit is to obtain an understanding of the company's research activities and development processes. Key to this process is understanding the services participating employees perform and determining whether related expenditures qualify as research expenses eligible for the R&D credit.

IRC Sec. 41 (d)(1)(A) states that "qualified research" means research with respect to which expenditures may be treated as expenses under IRC Section 174. Section 174 does not offer a direct definition of "qualified research," but rather it relies on the Treasury Department's regulations.

Under Regulation 1.174-2(a)(1), research and experimental expenditures ("R&D costs") are expenditures incurred in connection with the company's trade or business which represent research and development costs in the experimental or laboratory sense. The three most common class types of eligible R&D costs are: employee wages, supplies used in the conduct of qualified research, and eligible contract costs (IRC Sec. 41(b)(2)).

If related to a qualified research activity, the costs associated with leasing cloud-computing server space for software development may meet the classification of eligible R&D costs under IRC Sec. 41(b)(2)(A)(iii).

Under IRC Sec. 41(d)(3)(B), research is not qualified research if its purpose relates to style, taste, cosmetic, or seasonal design factors. Costs related to advertising, quality control testing, efficiency surveys, and the acquisition of another's patent, model, production, or process, among others, are specifically excluded as "qualified research" under Regulation 1.174-2(a)(6). In addition, Reg. Sec. 1.41-4(c) specifically excludes research activities, including research that is conducted after commercial production and research that is not performed within the United States.

IRC Sec. 41(d) contains three additional requirements for expenditures to qualify. To be eligible as "qualified research," the research must be (1) undertaken for the purpose of discovering information which is technological in nature; (2) substantially all of the research activities must constitute a process of experimentation; and (3) the experimentation must be related to a permitted purpose.

Costs incurred for the development of "internal use" software must meet additional requirements to qualify for the credit. Under IRC Sec. 41(d)(4)(E), research related to the development of "internal use" software will be considered as "qualified research" if it is: (1) related to software used in qualified research activities; (2) related to software used in a production process of the taxpayer; or (3) treated as "qualified research" under the regulations.

Developed software is presumed to be "internal use" if not developed to be commercially sold, leased, licensed, or otherwise marketed to outside parties. Internal use software may help the company with general and administrative functions and non-computer services such as accounting and finance functions. Software-as-a-Service ("SaaS") business operating models use software to provide computer services and are not typically subject to the higher threshold of "internal use." On the other hand, the software utilized by the United Parcel Service on its hand-held devices to track shipments and deliveries may be perceived as an example of "internal use."

A number of state jurisdictions also offer similar credits for companies investing in R&D and software development activities. A company that does not qualify for the federal R&D credit, including loss corporations, may benefit from available credits at the state level depending on the circumstances.

Quantification & Documentation

After costs have been quantified and determined to be "qualified research" expenses, there are two methods for calculating the R&D credit: 1) the Regular, or "Fixed Base" method; and 2) the Alternative Simplified Credit ("ASC"). Both methods were designed to promote ongoing investment in research activities.

The **Regular Method** calculates the R&D credit based upon 20 percent of the excess of R&D costs for the current tax year over a base period amount. The base period amount is determined from an analysis of historical R&D costs and a review of average annual gross receipts for the preceding four years.

The **Alternative Method** calculates the ASC based upon 14 percent of the excess of R&D costs over 50 percent of the average R&D costs for the three preceding tax years.

Alternative methods exist for start-up companies without a history of R&D costs and average annual gross receipts to calculate and claim the R&D credit.

In accordance with IRC Sec. 280C(c)(3), the company may elect to claim a reduced credit and avoid any reduction of the "qualified research" deduction under IRC Sec. 174. The reduced credit election provides the company with the "best of both worlds," as a full deduction is allowed for R&D expenditures which are used in calculating the R&D credit.

Substantial credits can be generated based upon a modest level of costs when the ASC and reduced credit election are used in conjunction with one another. A simple calculation is shown here to demonstrate the magnitude of the credit based upon the level of R&D costs.

Qualified Expenditures - Current Year	(A) $9,000,000
Total Qualified Expenditures for prior three years	*$15,000,000*
Average of total for prior three years	*$5,000,000*
50 percent of average	(B) $2,500,000
Current year expenditures allowed for credit	(A-B) $6,500,000
Alternative Simplified Credit ("ASC") Percentage	**14%**
Gross ASC (before reduction)	$910,000
Reduced Research Credit Percentage (as determined under IRC Sec. 280C(c))	**65%**
Total Reduced Current Year ASC (net tax benefit)	$591,000

The R&D credit is subject to the same limitations and carry-over rules as general business credits provided under IRC Sec. 38. The limitation imposed on current year utilization may be a trap for the unwary during a company's first few periods of profitability and needs to be assessed during tax planning.

It is imperative that companies claiming the R&D credit maintain contemporaneous documentation to substantiate the qualification of costs incurred and their relation to ongoing research and development activities. Software development companies have a deep understanding of their development process and will typically have development processes outlined. But they also may have invested in an accounting system that will help match project costs with qualifying activities.

Alternatives to Claiming the R&D Credit

As an alternative, a company may treat R&D expenditures paid or incurred during the tax year as business expense. Or, the company may elect to treat such expenditures as deferred expenses under IRC Sec 174(b) by capitalizing such expenses and amortizing them over a period of 60 months, beginning with the month the company first realizes benefits from such expenditures. For expenditures related to the development of computer software, amortization of costs typically begins when development is complete.

Availability of the Credit

The R&D credit is currently expired for activities commencing after Dec. 31, 2013. Generally, the credit has been historically extended on a year-by-year basis, and it seems reasonable to conclude that 2014 will be no different. Recent proposals for a permanent (or a period greater than one year) extension of the credit have received bipartisan interest on Capitol Hill but may lose traction for budgetary reasons. Given Congress's history of providing an extension of the R&D credit, it's wise for companies to evaluate current eligibility and maintain documentation of ongoing projects. ▲

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